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The Current LDC Debt Situation: Rising Frustrations

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An Intelligence Assessment

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An Intelligence Assessment

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[redacted]

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**The Current LDC
Debt Situation:
Rising Frustrations**

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Key Judgments

*Information available
as of 26 September 1985
was used in this report.*

Dissatisfaction with chronic financial problems is growing among debt-troubled LDCs. Heightening debtors' frustrations, moreover, is their inability to convince creditor nations that compliance with IMF-supported austerity programs is politically risky. The perception among governments and voters alike in these countries is that their financial obligations have become overwhelmingly burdensome, that living standards have suffered enough, and that multiyear debt reschedulings only postpone, rather than ease, the repayments burden. Thus, LDCs will continue to press industrial governments to share the costs they believe are required to make their external finances manageable.

With little significant economic improvement foreseen in the coming months, mounting political pressure and economic troubles have led the 11 Latin American nations of the Cartagena Group to examine proposals for interest payment relief. Already, Peru has chosen to limit its debt payments to a small percentage of export earnings. Most debt-troubled countries—even those that have been the voices for moderation during the past three years—are advocating increased funding for multilateral financial institutions such as the IMF and World Bank and greater financial participation by industrial governments.

Meanwhile, significant changes in the global economy are adversely affecting the availability of funds to LDCs. Countries that had been major net suppliers of funds, such as the United States and Saudi Arabia, are becoming net users. The financing of industrial country and OPEC current account deficits has become a significant factor that will influence the availability and cost of funds for LDC borrowers through the decade. The reluctance of Western banks to increase their loan exposure to many LDCs is another contributing factor. Consequently, we do not expect the resumption of spontaneous bank lending to many debt-troubled LDCs until their overall debt levels are substantially reduced, which is unlikely to occur in this decade.

We believe the challenge currently facing the international financial community is to find a "carrot" that can be used to reward debt-troubled LDCs that undertake substantial structural economic reforms. At present, short-term adjustments—devaluations and cuts in subsidies and wages—are being made, while the fundamental inefficiencies and rigidities of the debtors' economies go unaddressed. For example, LDCs must reduce

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government involvement in business and industry, strengthen private-sector enterprise, adopt export-oriented policies, and increase incentives for private and foreign investment.

Many financial observers suggest that the World Bank's lending must be expanded to help boost growth and development in debt-troubled countries. Although continuing their efforts in project financing, World Bank officials are just beginning to develop a more catalytic role for the Bank, including cofinancing with commercial banks, more structural adjustment loans, loan guarantees, and encouragement of direct private investment. These initiatives, however, are somewhat constrained by the Bank's limited resource base. Meanwhile, the IMF remains the focal point for short-term financial assistance. We believe, however, the Fund will resist expansion of its responsibilities through enhanced surveillance programs, which creditor governments and commercial banks have encouraged, because it does not want to be viewed as the "policeman" of the international financial community.

In our judgment, the debtors will use every available forum to push for financial relief by demanding that industrial countries:

- Implement sound economic policies to promote world growth and lower real interest rates.
- Resist protectionist tendencies and thereby provide open markets for LDC exports.
- Boost multilateral development resources, particularly for the World Bank and Inter-American Development Bank, to increase development lending.
- Reform some European regulatory environments, which currently restrict commercial bank lending to LDCs.

Their requests could come to a head this fall. For the first time, the LDCs have submitted proposed reforms—including easing conditionality of creditor lending and increasing international liquidity—for consideration at the upcoming IMF/World Bank annual meetings in Seoul. Moreover, the economic and foreign ministers of the Cartagena Group plan to meet soon. Given the current environment, we cannot rule out more radical demands or actions by debt-troubled countries, such as making only partial interest payments to commercial banks. In this regard, the Mexican Government bears the closest watching; its IMF program has been suspended, and economic and political pressure, which could intensify if oil prices continue to fall, could lead that country to be the first of the big three debtors—Brazil, Mexico, and Argentina—to confront creditors with alternate solutions to the LDC debt problem.

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The Current LDC Debt Situation: Rising Frustrations

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LDC Needs for External Funds Increase

The LDCs made marked improvements in their current account positions in 1984 and began to rebuild their reserves. Now, however, the current account performance of the key LDCs is deteriorating and some countries are drawing down their reserves. Many debt-troubled LDCs need to obtain new loans to meet interest payments, bolster reserves, make principal repayments, and develop their economies.

Current Account Positions Deteriorating

The positive adjustments in LDC current account balances that occurred in response to the debt crisis were surprisingly dramatic (table 1). [redacted] the aggregate current account deficit of nonoil LDCs was cut by two-thirds—from \$113 billion in 1981 to \$38 billion in 1984. The most impressive gains were made by Brazil and Mexico. [redacted]

Much of this improvement resulted from two overlapping conditions—the new era of extreme financial constraints and the shift from global recession to global recovery. Specifically:

- With the emergence of the debt crisis in 1982, voluntary lending, other than for short-term trade finance, became virtually unobtainable for many LDCs. This situation proved particularly painful for active market borrowers, such as Brazil and Mexico. The sharp adjustments (due to reduced credit) required by these borrowers were reflected in their import levels, which showed a steep decline starting in 1982.
- The improvement in the international economy—notably rapid US-led OECD economic growth and lower interest rates—that began in late 1983 also helped the current account performance of many debt-troubled LDCs, allowing them to expand exports and reduce interest payments during 1984.

This year, however, LDC current account performance is again deteriorating. Some LDCs, such as Mexico and Indonesia, have increased imports to foster economic growth and bolster living standards at a time when moderating OECD growth is slowing LDC exports; we expect the exports of the key LDCs to decline by \$10 billion this year—after a \$20 billion surge in 1984. Mexico has moved from a sizable current account surplus in 1983 and 1984 to an expected deficit of almost \$1 billion in 1985. Brazil and Venezuela are also experiencing a significant worsening in their current account positions. [redacted]

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Reserves Being Drawn Down

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After registering a \$6.4 billion buildup in 1983 and a \$13 billion increase in 1984, the reserves held by the nonoil LDCs have begun to decline, [redacted] The reserves of the nonoil LDCs as a group rose by 15 percent in 1984, the largest increase since 1980. The most dramatic gains were made by the Latin American countries, which increased their reserves by 56 percent to \$32 billion.

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LDC reserve positions are worsening this year, however, as countries are forced to finance their growing current account deficits with little access to new credits (table 2). As a larger percentage of reserves is used for current account financing, LDCs will be increasingly hard pressed to maintain their current level of imports. We believe import coverage ratios, which had improved dramatically through 1984, are now unlikely to be sustained.¹ [redacted]

Development Process Stagnating

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For many of the countries experiencing debt-servicing troubles, economic growth slowed during the first half of the 1980s. Despite the recent recovery of industrial

¹ Because reserves are used primarily to make interest payments or finance imports, the financial community uses import coverage ratios to determine how many months of imports can be funded by reserves—at least three months of coverage is desirable. [redacted]

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Table 1
Key LDC Debtors: Exports, Imports, and
Current Account Balances, 1981-85

Billion US \$

	1981			1982			1983			1984			1985 ^a		
	Exports	Imports	Current Account	Exports	Imports	Current Account	Exports	Imports	Current Account	Exports	Imports	Current Account	Exports	Imports	Current Account
Total	191.1	203.4	-56.0	178.4	181.0	-60.6	179.7	162.2	-26.1	200.1	163.0	-7.5	190.4	162.7	-13.1
Brazil	23.3	24.1	-11.7	20.2	21.1	-16.3	21.9	16.8	-6.8	27.0	15.2	-0.1	25.5	13.5	-2.0
Mexico	19.6	24.1	-13.9	21.2	15.1	-5.7	21.8	8.0	5.2	24.4	11.3	4.0	22.2	15.0	-0.8
South Korea	21.2	26.1	-4.6	21.8	24.2	-2.6	24.4	26.2	-1.6	29.2	30.6	-1.4	29.5	30.0	-1.3
Argentina	9.1	9.4	-4.7	7.6	5.3	-2.3	7.8	4.5	-2.4	8.1	4.6	-2.5	7.7	4.6	-2.0
Indonesia	22.3	13.3	-0.6	22.3	16.9	-5.3	21.1	16.3	-6.3	21.9	13.9	-2.1	20.5	14.7	-1.8
Venezuela	20.2	12.1	4.0	16.5	12.6	-4.2	14.8	6.4	4.4	15.9	7.9	5.0	13.4	7.2	2.5
Philippines	5.7	7.9	-2.1	5.0	7.7	-3.2	5.0	7.5	-2.7	5.4	6.1	-1.2	4.8	5.5	-1.0
Egypt	3.2	8.8	-2.1	3.1	9.1	-2.2	3.2	10.3	-0.8	3.6	10.3	-0.9	3.6	10.4	1.3
India	8.7	15.5	-3.2	9.4	15.2	-3.0	9.6	15.3	-2.8	9.5	14.0	-2.1	8.8	13.3	-2.2
Nigeria	17.9	18.9	-5.8	12.1	14.8	-7.2	10.5	11.4	-4.2	11.9	8.9	0.5	10.5	9.0	0.1
Chile	3.9	6.4	-4.7	3.7	3.5	-2.3	3.8	3.0	-1.1	3.7	3.2	-2.1	3.8	3.3	-1.8
Malaysia	11.7	11.8	-2.5	11.9	12.7	-3.5	13.8	13.2	-3.1	16.3	14.3	-2.2	16.3	14.0	-1.9
Algeria	14.1	11.3	0.1	13.5	10.7	-0.2	12.7	10.4	-0.1	12.8	10.3	-0.1	13.4	10.6	0.0
Thailand	6.9	9.9	-2.5	6.8	8.4	-1.0	6.3	10.2	-2.9	7.3	10.3	-2.1	7.3	9.5	-1.8
Peru	3.3	3.8	-1.7	3.3	3.7	-1.6	3.0	2.7	-0.9	3.1	2.1	-0.2	3.1	2.1	-0.4

^a Projected.Sources: *International Financial Statistics* and CIA estimates.

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Table 2
Reserve Positions of the Key Debtors

Billion US \$

	Yearend 1983	Yearend 1984	End of June 1985	Percent Change, 1984/85
Brazil	4.2	11.7	11.4	-2.6
Mexico	3.7	7.4	4.5	-39.2
South Korea	6.9	7.6	6.6	-13.2
Argentina	1.1	1.3	1.2 ^a	-7.7
Indonesia	3.5	4.9	4.9	0
Venezuela	7.3	9.1	9.9	8.8
Philippines	0.7	0.6	0.7	16.7
Egypt	0.7	0.7	0.9 ^b	28.6
India	4.7	6.0	6.2 ^c	3.3
Nigeria	0.9	1.5	1.2	-20.0
Chile	1.9	2.3	1.7	-26.1
Malaysia	3.6	3.8	4.0	5.3
Algeria	1.8	1.5	2.5	66.7
Thailand	1.6	1.9	2.1	10.5
Peru	1.3	1.6	1.5 ^d	-6.2

^a End of May figure.

^b End of April figure.

^c End of March figure.

^d End of January figure.

Source: *International Financial Statistics* and CIA estimates.

economies and LDC adjustments, the debt-troubled countries have neither returned to the robust growth rates of the 1960s nor significantly boosted economic development. [] the average per capita incomes of many African and Latin American countries are the same in real terms as they were in the 1970s, and LDC economic growth over the last five years is only one-half the rate achieved in the 1970s. []

LDC exports in 1980-85 have grown close to 6 percent a year, but, due to interest payments, import growth has been little more than 1 percent a year. As export earnings are increasingly used to make interest payments, LDCs have fewer resources available to fund development projects. Net financial outflows from Latin America last year totaled almost \$30 billion,

most of it tied to external debt, []
[]
[] the financial strains of the past few years have caused many LDCs to lose at least a decade of development. []

Tightening Supply of Credit

Significant changes in the global economy are adversely affecting LDC access to new money. An important shift occurred during the past several years as countries that had been major suppliers became net users of funds. OPEC's huge infusion of investable funds during 1974-84 ended as world oil markets

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softened and Saudi Arabia and other members slid into deficit. The aggregate current account position of industrial countries also deteriorated, although this trend masks large disparities within the group: the United States has the largest deficit, while Japan is running a huge surplus. The financing of industrial country and OPEC current account balances will significantly influence the availability and cost of funds for the generally riskier LDC borrowers.

In addition, commercial banks remain reluctant to lend to debt-troubled LDCs until they are better able to service their interest and principal payments. Long-term bank lending is down from \$41 billion in 1983 to \$25 billion in 1984, and, according to OECD data, short-term bank lending to LDCs fell \$5 billion.

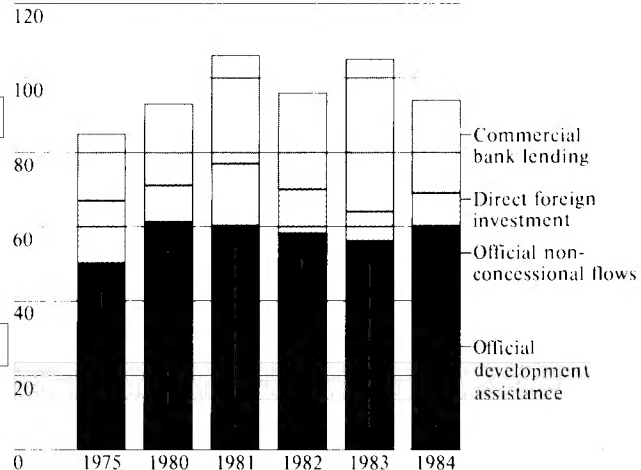
At the same time, other sources of financing—official transfers and credits and direct investment—have been relatively stable (see figure). In our view, these sources of funds are unlikely to grow for most debt-troubled LDCs because:

- The bulk of official development assistance will continue to be directed toward poorer countries that do not depend heavily on Western bank financing.
- Other official flows, such as official export credits and multilateral institution lending, are not likely to rise much, given budgeting constraints in both industrial countries and OPEC.
- Foreign direct investment is not likely to increase significantly during the second half of the decade, primarily in light of economic problems in many LDCs.
- LDC bond financing is only a minor source of funds, and investors will continue to be reluctant to purchase these bonds in view of poor LDC creditworthiness.

Increasing Politicization of the Debt Issue

The LDC financial situation remains serious, and political frustrations are more and more evident. Balance-of-payments troubles, the lack of a dialogue on debt with creditor governments, and IMF compliance difficulties are heightening debt-troubled countries' disgruntlement. Many governments—especially in Latin America—are under increasing political

Net Financial Flows to LDCs in Selected Years, 1975-84

Billion 1983 US \$^a

^a Data adjusted to eliminate exchange rate fluctuations.

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pressure to obtain new financial agreements with creditors to ease their foreign debt burden and to boost economic growth. For example:

- President Sarney of Brazil is reluctant to make additional cuts in government spending because of intensive domestic political pressure to continue the economic recovery. On the opening day of the UN General Assembly, he called for "concerted political action" on the debt issue.
- President de la Madrid of Mexico is facing increasing pressure from the public against new government cutbacks and for finding an alternative to Mexico's present debt arrangements.
- President Lusinchi of Venezuela is under strong pressure from the political opposition and labor groups to abandon the multiyear rescheduling agreements.

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- President Garcia of Peru has refused to negotiate with the Fund because he fears the potential economic and social consequences. He threatened in his recent UN speech to withdraw from the IMF if LDC demands for international monetary system reform are not listened to, according to press reporting. [redacted]

In response to these pressures, Latin leaders have publicly stated that their external debt problem is far from being solved and that it continues to be an obstacle to economic development and to the strengthening of their political democracies. They believe that multiyear debt reschedulings only postpone repayments and do not provide a long-term solution to their problem. Moreover, there is little enthusiasm for an indefinite transfer of resources from debt-troubled countries, even under global conditions that make export surpluses feasible. Thus, these leaders support a two-track approach to resolving their financial burden: servicing their debt to the best of their ability, while concurrently seeking more concessions. [redacted]

Cartagena Moves to Center Stage

Latin American countries have occasionally met among themselves during the last three years to discuss their debt troubles and alternative solutions. The most serious effort to act collectively arose in June 1984, when 11 Latin debtors formed the so-called Cartagena Group² at a meeting in Cartagena, Colombia. The group, consisting of foreign and economic ministers, has met several times to try to arrange a political dialogue on debt between Latin American and industrial country governments, and to obtain more dramatic solutions to their debt problems. By late 1984, some of the complaints of the Cartagena had been diffused as dollar-denominated interest rates fell and Latin trade balances showed substantial improvement. [redacted]

Since August 1985, however, some Latin leaders—including Brazilian Foreign Minister Setubal and Uruguayan Foreign Minister Iglesias—have been seeking to strengthen the Cartagena Group because they view it as the best forum to discuss the political

² The Cartagena Group consists of Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay, and Venezuela. [redacted]

aspects of Latin America's foreign debt problem, according to Embassy and press reporting. In recent meetings, the group's attention has centered on preparations for a greater dialogue with the European Community, which has shown a willingness to listen to their concerns. The Cartagena Group has also begun to examine proposals for interest payment relief and has come out strongly advocating increased funding for the multilateral institutions, particularly the World Bank and the Inter-American Development Bank. [redacted]

Other Calls for Action

Numerous individual proposals also have been made:

- President Garcia's move to link debt-service payments to exports and to restructure Peru's bank debt without seeking IMF support has not gone unnoticed by other Latin debtors, according to Embassy and press reporting. Some financial observers believe this approach could foreshadow similar actions by additional debt-troubled LDCs. However, [redacted]

[redacted] Peru could follow the Argentine experience; Argentina attempted to skirt the IMF during most of 1984 but, due to pressure from creditors, was forced to negotiate a new IMF arrangement in August 1985. Nevertheless, Garcia's statements put other Latin leaders in the difficult position of explaining to their constituents why they have taken the more orthodox route.

- Fidel Castro is attempting to exploit the debt issue, giving numerous speeches and interviews. He has urged Latin Americans to stage "a general strike of debtors" to demonstrate their firmness, according to Embassy and press reporting. Castro's crusade for Latin American debt relief has also included a series of conferences sponsored by Havana that are designed to gain broad-based support for the issue and to antagonize US relations with the region. These conferences have generated extensive diplomatic and media attention.

- Colombian President Betancur and most Latin leaders reject Fidel Castro's idea of a debt moratorium as unworkable and outside the system of international cooperation, according to Embassy and press

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reporting. Betancur, however, supports a call for an OECD-financed "Marshall Plan" for Latin America and has offered two other methods of relieving Latin debt burdens. One idea calls for each industrial country to transfer 1 percent of its GNP annually as soft credits to LDCs. The second proposal is a 5-percent tax on OECD military expenditures to finance lower interest rates for loans to LDCs.

- Mexican Finance Secretary Silva Herzog has stated that an equilibrium must be found between the amount of debt servicing paid to commercial banks and the debtor's economic growth, according to press reporting. We believe this trade-off is the driving force behind the growing Latin sentiment for some kind of interest payment relief. One scheme recommended by several financial experts would effectively reduce interest paid to the real interest rate by capitalizing the portion of the interest payment that reflects US inflation. This would provide debt-troubled countries with more funds to stimulate economic growth.
- Antonio Ortiz Mena, the President of the Inter-American Development Bank, wants to use part of the interest paid by debtors to commercial banks to set up a fund administered by his bank and the World Bank to provide long-term development assistance, according to press reporting. Under his proposal, Latin American debt would be classified to identify a category of "bad debt"—money borrowed for military or pure consumption purposes. Half of the interest due on this debt would go into the trust fund to be loaned to debtors for projects designed to earn foreign exchange. [redacted]

Outlook

We believe the key to overcoming LDC financial problems remains a cooperative effort among the LDCs, commercial banks, their regulators and governments, and the multilateral financial institutions. Even so, the resolution of these problems presupposes a number of favorable world economic conditions:

- Sustained OECD economic growth of at least 3 percent during the next several years.
- Steady or falling dollar interest rates.
- Open markets in major industrial economies.

- A gradual fall in the value of the dollar against European currencies and the yen.
- An increase in the availability of medium- and long-term foreign credit.
- Slight or only moderate changes in oil prices. [redacted]

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During the next 15 months, however, we expect a much less favorable external environment. OECD growth will probably not average the desired 3-percent rate, according to the OECD Secretariat. This slower growth will reduce demand for LDC exports and probably will fuel increased OECD protectionism. At the same time, [redacted] expect interest rates to trend upward, and oil prices could well fall substantially—hurting such oil-exporting countries as Mexico, Venezuela, and Indonesia. [redacted]

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The continued pressure on LDCs' trade balances will exacerbate their need for external financing. We believe that, despite a reluctance to do so, the financial community will have to address these needs and continue forced lending. Mexico, for example, is likely to need at least \$3 billion in new loans within the next six months. An alternative plan for interest capitalization would weaken debtor discipline and wreak havoc with US accounting practices, [redacted]

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Needed LDC Action

We believe that LDC financial adjustment measures such as devaluations and cuts in subsidies and wages must be complemented by fundamental structural reforms. To restore creditworthiness, bankers say that debtors must strengthen the private sector, reduce government involvement in business and industry, increase incentives for private and foreign investment, and adopt export-oriented policies. In our view, efforts in this direction will also reduce rigidities of debtor economies, restore healthy domestic economic growth, and improve foreign exchange positions. Furthermore, these actions would make the domestic financial environment more attractive, slow the rate of capital flight, and could lead to the actual repatriation of capital. Structural reforms, however, are extremely difficult to undertake because they represent attacks

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***The Politics of Structural Adjustment:
The Case of Public-Sector Reform***

The rapid growth of state-owned enterprises during the 1970s and early 1980s was supported by large-scale external borrowings. As a result of the debt crisis, many LDCs—including Mexico, Brazil, and the Philippines—are now being urged to reduce their involvement in inefficient public enterprises and contain public-sector spending. Creditors believe that the current level of public-sector borrowing has crowded out investment in the private sector; they are urging a reallocation of savings to strengthen private enterprise. [redacted]

LDC government leaders have shied away from state enterprise reform, however, because of the high potential for political fallout. Such reforms can severely interfere with the vested interests of key political supporters. For example, in the Philippines, the brunt of reform in the coconut and sugar monopolies would fall heavily on two of Marcos's key political associates, who provide support for his administration. Fear of unrest arising from public-sector unemployment also can inhibit reform. [redacted]

The political sensitivity of domestic structural changes has resulted in only superficial reform efforts by many LDCs, causing them to fall out of compliance with their IMF-supported adjustment programs. This is a particular problem in democratic countries, where newly elected leaders or those facing upcoming elections are reluctant to alienate key constituencies. Public-sector reform—just one of the structural changes encouraged by the international financial community—illustrates the difficulties LDC governments face in implementing such adjustments. [redacted]

on entrenched interest groups whose support is usually essential to LDC leaders' maintenance of political power. [redacted]

Financial Community Response

The adjustment efforts of the LDCs will require the support of commercial banks, multilateral organizations, and industrial donor governments. We believe

the challenge currently facing the international financial community is to find a "carrot" that can be used to entice LDCs to make structural changes in their economies. At present, the adjustments made are of a short-term nature, while the fundamental inefficiencies and rigidities of the debtors' economies go unaddressed. Commercial banks, creditor governments, and the multilateral institutions agree that LDCs will not be inclined to undertake politically sensitive structural changes until such actions are tied to financial assistance. [redacted]

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Voluntary lending by commercial banks to most debt-troubled countries—including Brazil, Mexico, Argentina, and the Philippines—is unlikely to occur in this decade. Only a few Latin American countries—those, like Venezuela and Colombia, in better financial shape—could perhaps receive new voluntary loans from banks within the next two years. In general, banks are trying to contain their concentrations of LDC risk and to lower their LDC exposure relative to capital, according to financial reporting, and a resumption of voluntary lending is not expected until overall LDC debt levels are reduced. Even when that occurs, lending to LDCs will be less of a priority to banks. US banks, for example, will be focusing on new opportunities in interstate banking and investment banking. [redacted]

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The lack of commercial bank lending to LDCs has led some US officials and commercial bank officers to suggest that the World Bank's role be enhanced to help boost growth in financially troubled countries. While continuing their efforts in project financing, World Bank officials are just beginning to develop a more catalytic role for the Bank through new and expanded programs, such as cofinancing with commercial banks, structural adjustment loans, loan guarantees, aid coordination, collaboration with export credit agencies, and the encouragement of direct private investment. Attention is focusing on using more of the Bank's resources to finance structural adjustment loans, which are longer term lending programs designed to achieve gradual changes in the debtors' economies rather than the more abrupt belt-tightening required by the IMF. The World Bank is

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Capital Flight: A Serious Drain

Large-scale capital flight has contributed significantly to LDC financial troubles, exacerbating the debtors' financing needs and forcing them to borrow simply to balance their international accounts. According to various sources, one-third to one-half of the funds loaned to the LDCs between 1978 and 1983 flowed back out in the form of capital flight. These outflows drained official reserves and denied the countries productive use of their foreign borrowings.

Capital flight is usually associated with several factors:

- *Overvalued exchange rates make foreign assets more attractive and spark domestic fears of devaluation.*
- *Repressive financial policies hold interest rates at negative levels during periods of high inflation and, as a result, cause domestic assets to lose their value.*
- *Political and economic instability leads individuals to seek a safe haven for their assets.*
- *Corruption in government circles funnels money out of the country.*

Under IMF-supported programs, many countries have devalued their currencies and raised interest rates in an attempt to make their domestic markets more attractive and to stem capital outflows. Capital flight peaked in 1982, falling off dramatically in 1983 and 1984; however, it is on the rise again. In Mexico, capital flight during the first half of 1985 is already double the total for 1984, according to a variety of sources. If capital flight continues to increase and as reserves are drained, the financing needs of the LDCs will undoubtedly exceed projected levels.

also developing a special fund to provide economic assistance in Sub-Saharan Africa. These initiatives, however, remain somewhat constrained by the Bank's limited resource base.

While the World Bank attempts to increase its medium- and long-term assistance to LDCs, the IMF remains the focal point for short-term financial assistance. During the next few years, however, we believe

the Fund will resist expansion of its scope of responsibility through enhanced surveillance programs, which creditor governments and commercial banks have encouraged, because Fund officials have said they do not want to be viewed as the "policemen" of the international financial community. Although the Fund will continue to monitor and assess its members' economies, Fund officials fear that their reports will be viewed as "on/off" indicators of financing.

The Fund's role in assisting debt-troubled countries is likely to diminish because of the current schedule of debtor repayments due to the Fund. According to OECD estimates, the Fund currently has a record amount—about \$35 billion—of financial assistance outstanding, and substantial repayments are due to begin during the next two years. Scheduled repayments will climb from \$3.4 billion this year to a peak of about \$8 billion annually during 1987-89. The two largest IMF debtors—Brazil and Mexico—are due to start repaying their current loans in 1986. Consequently, the IMF could well become a net recipient rather than a net provider of funds unless repayments are rescheduled—a move the Fund strongly opposes for prudential reasons.

LDC Political Initiatives

The financial problems that are being experienced by many LDCs are becoming a unifying concern for Third World leaders. In our judgment, these leaders will use every available forum to push for financial relief by demanding that industrial countries:

- Implement sound economic policies to promote world growth and lower real interest rates.
- Resist protectionist tendencies and thereby provide open markets for LDC exports.
- Boost multilateral development resources, particularly for the World Bank and Inter-American Development Bank, to increase development lending.
- Reform some European regulatory environments, which currently restrict commercial bank lending to LDCs.

Their requests could come to a head this fall. For the first time, the LDCs have submitted proposed reforms of the international monetary system for consideration at the upcoming IMF/World Bank annual

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**G-24 Proposals for Improving
the International Monetary System**

Renewed LDC dissatisfaction with current international monetary arrangements has bolstered Third World resolve to urge reform during the IMF/World Bank annual meetings next month in Seoul. For the first time, LDCs have submitted proposed modifications for formal consideration by the IMF Interim Committee in response to the recommendation proposed by the G-10 countries in June:

- *"Volatile exchange rates have discouraged world trade and investment in developing countries needed to service foreign debt." Although LDCs favor eventually establishing target zones for exchange rates, they intend, in the meantime, to press major industrial countries to coordinate macroeconomic policies by submitting to an explicit, two-stage consultation process with the IMF.*
- *"Increased economic interdependence has placed the burden of international adjustment on developing countries." The Third World believes that the Fund should tighten surveillance over the monetary and fiscal policies of industrial countries and promote economic growth as an integral part of LDC adjustment, partly by easing conditionality of international lending.*
- *"International liquidity is insufficient." LDCs favor augmenting the loan base of the IMF and the World Bank.*

Although the industrial countries share LDC concern about key features of the monetary system—especially exchange rate volatility—most remain unwilling to support extensive reform. The majority of G-10 countries oppose the adoption of target zones at this time and have reached no consensus on an additional SDR allocation. Instead, they hope to reduce exchange rate fluctuations by improving the effectiveness of existing, informal arrangements to coordinate macroeconomic policies—a strategy they jointly approved this summer. Consistent and sound macroeconomic policies in industrial countries also would foster greater private lending to LDCs, argue the United States, West Germany, and the United Kingdom, easing pressure to increase international liquidity with official funds.

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LDCs, however, may try to exploit differences of opinion existing among individual industrial countries to garner international support for monetary reform. France and Italy, in particular, have supported the concept of target zones. Only a brief discussion of the G-10 and G-24 reports is expected at the October meeting, with further in-depth discussion to be held at the spring Interim Committee meeting.

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meetings in Seoul. These include coordinating industrial countries' exchange rate policies, easing conditionality of international lending, and increasing international liquidity with an additional special drawing rights (SDR) allocation. Moreover, the economic and foreign ministers of the Cartagena Group also plan to meet soon, according to press reporting. Given the current environment, we cannot rule out more radical demands or actions by debt-troubled countries. In this regard, the Mexican Government bears the closest watching; its IMF-supported

program has been suspended, and economic and political pressures, which will intensify if oil prices continue to fall, could lead that country to be first of the big three debtors—Brazil, Mexico, and Argentina—to confront creditors with alternate solutions to the LDC debt problem. At a minimum, the recent earthquake and publicity on Mexico's options on debt enhance its negotiating position with creditors.

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